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No. 98-1949

In the
Supreme Court of the United States

LORI PEGRAM, M.D., CARLE CLINIC ASSOCIATION, AND HEALTH ALLIANCE MEDICAL PLANS, INC.
Petitioners,

v.

CYNTHIA HERDRICH,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF OF *EHLMANN* PLAINTIFFS AS *AMICUS CURIAE* SUGGESTING AFFIRMANCE

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38 pp

TABLE OF CONTENTS

TABLE OF CITED AUTHORITIES

	Page
Cases:	
Anweiler v. American Elec. Power Serv. Corp., 3 F.3d 986 (7th Cir. 1992)	22, 25
Bailey v. Blue Cross/Blue Shield of Va., 866 F. Supp. 277 (E.D. Va. 1994), *aff'd*, 67 F.3d 53 (4th Cir. 1995)	15
Basic Inc. v. Levinson, 485 U.S. 224 (1988)	6
Central States, Southeast & Southwest Areas Pension Fund v. Central Transport, Inc., 472 U.S. 559 (1985)	9
Curtiss-Wright Corp. v. Schoonejongen, 514 U.S. 73 (1995)	9
Donovan v. Bierwirth, 680 F.2d 263 (2d Cir. 1982)	10
Eddy v. Colonial Life Ins. Co., 919 F.2d 747 (D.C. Cir. 1990)	14, 20, 21, 22
Ehlmann v. Kaiser Foundation Health Plan, Inc., Docket No. 98-11020	1, 2, 3, 4
Everson v. Blue Cross & Blue Shield, 898 F. Supp. 532 (N.D. Ohio 1994)	25

INTEREST OF THE *AMICUS CURIAE*[1]

Amicus curiae consists of beneficiaries of employee welfare benefit plans, protected by the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1001, *et seq*. *Amicus curiae* also subscribes to various national health maintenance organizations (HMOs) which, like the HMO in this case, have financial incentive arrangements with their physicians designed to minimize care. Currently pending before the Fifth Circuit Court of Appeals is a suit filed by *amicus curiae*, *Ehlmann v. Kaiser Foundation Health Plan, Inc.*, Docket No. 98-11020, Fifth Circuit Court of Appeals (fully briefed; oral argument heard October 5, 1999).[2] The *Ehlmann* Plaintiffs filed breach of ERISA fiduciary duty claims against various HMOs/ERISA fiduciaries based in part on the failure to disclose to the participants and beneficiaries of ERISA plans the material information that the HMOs impose financial incentives upon treating physicians.[3]

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[1] Pursuant to Supreme Court Rule 37.6, *amicus curiae* states that no counsel for a party authored this brief in whole or in part and that no person or entity, other than *amicus curiae*, contributed monetarily to the preparation and submission of this brief. The parties granted consent to the filing of this brief of *amicus curiae*; the letters of consent are being filed herewith.

[2] The individual plaintiffs in *Ehlmann* are Mary Ellen Ehlmann, Albert DeJohn, Carolyn Salters, Robert Whitacre, Sally Slagle, Carol and Jimmy Pressly, and Debra McDonald.

[3] *Amicus curiae* respectfully suggests in the following discussion that *failure to disclose* material facts is the key element in a breach of ERISA fiduciary duty claim based on the existence of an HMO's financial incentives, a position closely aligned with the opinion of Judge Flaum's dissent from the Seventh Circuit's decision. *See Herdrich v. Pegram*, 154 F.3d 362, 380 (7^{th} Cir. 1998).

The *Ehlmann* suit addresses the HMOs' breach of their ERISA fiduciary duties as ERISA plan administrators acting with discretionary authority. The ERISA fiduciary HMOs owe the ERISA plan members the traditional fiduciary duties of undivided loyalty under both ERISA and the common law of trusts. Yet, the *Ehlmann* Plaintiffs allege the HMOs seek to maximize the HMOs' profits as health care providers by giving doctors *undisclosed* incentives to deny or minimize medical care provided for ERISA plan members. Contrary to the ERISA beneficiaries' best interests, the ERISA patients are *uninformed* of the strong financial incentives which may influence, consciously or subconsciously, their physicians' diagnosis and recommended course of treatment by encouraging the physicians to provide the least costly, over the most appropriate, medical care. Accordingly, the *Ehlmann* Plaintiffs allege that the HMOs breach their ERISA fiduciary duties: the HMOs failed to disclose to participants that they established and implemented a financial incentive scheme at the expense of and in conflict with the interests of ERISA plan participants and beneficiaries. On the HMO defendants' motion, the district court dismissed the *Ehlmann* Plaintiffs' claims, finding that ERISA fiduciaries have no duty to disclose except as identified in the reporting and disclosure requirements for ERISA plan administrators, ERISA § 101, *et seq.*

On appeal, the *Ehlmann* Plaintiffs urged the Fifth Circuit to find that an HMO's ERISA fiduciary duties include a duty to disclose the material facts of an HMO's financial incentives, as found by the Eighth Circuit in *Shea v. Esensten*, 107 F.3d 625 (8th Cir.), *cert. denied*, 118 S. Ct. 297 (1997).[4] *Shea* determined that an HMO's imposition of financial incentives creates a danger to the plan participant's well being—a clear

[4] *Shea* is discussed in greater detail in section II.B. below.

conflict between the interest of an ERISA plan participant, and the interest of the HMO's bottom-line—and that the HMO ERISA fiduciary's failure "to disclose [these] material facts affecting the participant's health care interests" rises to the level of a breach of ERISA fiduciary duty. *Shea*, 107 F.3d at 629.

If the Fifth Circuit rules in *Ehlmann* contrary to the Eighth Circuit's opinion in *Shea*, and in the absence of guidance from the Court clarifying the Seventh Circuit's determination in *Herdrich* that financial incentives give rise to an ERISA breach of fiduciary duty claim *upon the HMO's failure to disclose* material facts of the HMO's self-dealing financial incentive scheme, there will be a split in the circuits on the issue of an ERISA fiduciary's duty of disclosure.

To aid the Court in deciding the issues raised, *amicus curiae* files separately to emphasize the analysis for determining fiduciary duties under ERISA, which include the duty to disclose self-dealing, financial incentives resulting in conflicts of interest, as well as emphasizing the analysis for determining fiduciary status—as similarly examined by the Court in *Varity Corp. v. Howe*, 516 U.S. 489 (1996). Contrary to Petitioner HMO's cries of undermining managed care nationwide, affirming the Seventh Circuit's finding that financial incentives rise to the level of a breach of fiduciary duty—with the clarification that the breach of fiduciary duty occurs *when* the material facts of the *financial incentives are not disclosed* to participants and beneficiaries—ensures the fulfillment of the goals of Congress in enacting ERISA to protect employees participating in welfare benefit plans and allows HMOs to continue to use such "tools of managed care" which Petitioners seem so anxious to protect. Indeed, the position of Judge Flaum's dissenting opinion as urged by *amicus curiae* allows Petitioner HMO and other similarly situated HMOs to continue

utilizing financial incentives tied to treatment decisions—as long as fully disclosed—and protects the rights of ERISA participants and beneficiaries to be fully informed as Congress intended. 29 U.S.C. § 1001.

Amicus curiae files this brief because of an interest in aiding the Court in determining an issue affecting ERISA plan members nationwide who subscribe to HMOs utilizing financial incentive schemes. *Amicus curiae* has no direct financial or economic interest in the outcome of this suit other than their interest in the *Ehlmann* case which involves similar issues pending before the Fifth Circuit Court of Appeals. *Amicus curiae*—providing a perspective distinct from that of any party—proffers assistance through a detailed analysis applying the common law of trusts incorporated by Congress to determine the ERISA fiduciary duty issue presented herein.

SUMMARY OF ARGUMENT

The parties' arguments exemplify polarity: Respondent contends that the existence of Petitioners' financial incentives, alone and without more, supports a breach of ERISA fiduciary duty claim. Petitioners contend that their financial incentive structure does not precipitate a breach of ERISA fiduciary duty claim, and argue that a contrary opinion will signify the end of managed care as we know it. *Amicus curiae* respectfully suggests to the Court that neither extreme position argued by the parties is consistent with the goals of ERISA or with the principles of the law of trusts.[5]

[5] *Amicus curiae's* position does not foreclose the possibility that, as noted in Judge Flaum's dissenting opinion, financial incentives alone *may* support a breach of ERISA fiduciary duty claim in rare and acute circumstances. *Herdrich v. Pegram*, 154 F.3d 362, 384 (7th Cir. 1998).

Amicus curiae agrees with Judge Flaum's dissenting opinion that the mere existence of an asserted conflict of interest does not, "*without more*, give[] rise to a cause of action for breach of fiduciary duty under ERISA." *Herdrich v. Pegram*, 154 F.3d 362, 381 (7th Cir. 1998) (emphasis added).[6] Following common law trust principles, the dissent wisely recognized that the essential element of an ERISA breach of fiduciary duty claim based on such financial incentive arrangements is an allegation that the fiduciary *failed to disclose* material facts of conflicts of interest to the participant or beneficiary, as found by the Eighth Circuit in *Shea*. *Herdrich*, 154 F.3d at 383 (citing *Shea v. Esensten*, 107 F.3d 625 (8th Cir.), *cert. denied*, 139 L. Ed. 2d 229, 118 S. Ct. 297 (1997)) (emphasis added). "The complaint in the instant case ... never asserts that the plaintiff's health plan *failed to disclose* the financial incentives under which its physicians were operating." *Herdrich*, 154 F.3d at 383 n. 2 (emphasis added).

Recognizing that "dual loyalties are not per se unlawful" because "ERISA tolerates some conflict of interest on the part of fiduciaries," Judge Flaum opined that "market forces help reduce the risk that the fiduciary's conflict of interest in making coverage decisions will work to the detriment of the plan and the plan beneficiaries." *Id.* at 381. However, the dissent found that the role of the courts, to protect beneficiaries and enforce ERISA fiduciary duties, "is triggered when the market

[6] Judge Flaum authored the opinion, cited and quoted herein, dissenting from the majority panel opinion in *Herdrich v. Pegram*, 154 F.3d 362 (7th Cir. 1998). Judge Easterbrook, quoted extensively by Petitioners, authored the opinion dissenting from the denial of the petition for rehearing *en banc* in *Herdrich v. Pegram*, 170 F.3d 683 (7th Cir. 1999).

fails"—such as when information about the financial incentives are not disclosed to plan sponsors and beneficiaries.[7] *Id.* at 383.

Urging an elaboration on Judge Flaum's dissenting opinion rather than either more extreme position of the parties, *amicus curiae* presents an examination of ERISA's legislative history and an application of trust law principles which reveals an ERISA fiduciary *duty to disclose.*[8] The duty to disclose is

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[7] Unlike Judge Flaum's dissenting opinion, J. Easterbrook's market analysis fails to address or even acknowledge the element essential to insuring that market forces do indeed provide the desired protection for consumers/patients, i.e. full disclosure of material information—the sum and substance of *amicus curiae*'s position herein. The importance of material information being disseminated to the public is not a new concept but is one the Court has noted and discussed in other important market contexts. *See Basic Inc. v. Levinson*, 485 U.S. 224, 246 (1988) (citation omitted) (discussing the definition of "materiality" in the SEC context, the Court noted that "[j]ust as artificial manipulation tends to upset the true function of an open market, so the *hiding and secreting of important information obstructs the operation of the markets* as indices of real value.") (emphasis added); *Greater New Orleans Broadcasting Ass'n., Inc. v. United States*, 119 S. Ct. 1923, 1930 (1999) (in determining that commercial speech conveying truthful information about lawful activities was entitled to First Amendment protections, the Court noted the importance of the dissemination of "accurate information as to the operation of market competitors, . . . which can benefit listeners by informing their consumption choices and fostering price competition."). Consistent with the Court's prior opinions recognizing the importance of disclosing complete and accurate material information, the position of *amicus curiae* allows Petitioner HMO, and other similarly situated HMOs in the health care market, to continue utilizing a favorite "tool of managed care"—physician financial incentives tied to treatment decisions—as long as the incentives are *disclosed* to ERISA members/patients.

[8] Petitioner HMO specifically admits that, as an ERISA fiduciary, Petitioner HMO has the duty to disclose information to plan participants and beneficiaries as required under ERISA. Reply Brief of Petitioners at

triggered when a self-dealing financial incentive scheme, such as at issue here, gives rise to conflicts of interest involving an ERISA fiduciary. Petitioners admit occupying the dual roles of ERISA fiduciaries (Reply Brief of Petitioners at 6-7, *Pegram v. Herdrich*, 120 S. Ct. 10 (1999) (No. 98-1949)) and for-profit health care providers (Petition for Writ of Certiorari at 3-4, *Pegram v. Herdrich*, 120 S. Ct. 10 (1999) (No. 98-1949)), and do not deny the conflicts of interest resulting from Petitioner HMO's self-dealing, physician financial incentives as alleged by Respondent Patient. Common law trust principles, which legislative history shows Congress adopted to aid in defining the broad fiduciary duties in ERISA § 404, explain that the only way Petitioner HMO may avoid a breach of ERISA fiduciary duty claim based on conflicts of interest is through *disclosure* of the material facts—the strong financial incentives to physicians to give less care—to ERISA plan participants and beneficiaries.

The problem resulting from the conflict of interest arising out of Petitioner HMO's dual roles is clear: although ERISA plan assets are used to implement the financial incentive arrangements, the benefits and profits flowing from the "success" of the financial incentive scheme go to Petitioner HMO as a health care provider, not to the Plan. Indeed, contrary to the interests of participants and beneficiaries, Petitioners' financial incentive structure is designed to minimize health care and maximize profits and bonuses to Petitioners as health care providers. Such conflicts of interest necessarily

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7 (in response to Respondent's original Count III, "in which she asserted that Carle Clinic *failed to disclose* certain material facts,. . . . Petitioners freely acknowledge[d] that they are plan fiduciaries when they engage in activities denominated as fiduciary by ERISA, *e.g.*, when they provide information to participants as required under ERISA and when they make decisions about who is eligible for plan benefits.").

trigger Petitioner HMO's ERISA fiduciary duty to disclose the material facts regarding the financial incentive arrangements.

Petitioners' argument does not address the essential "disclosure" element of an ERISA breach of fiduciary duty claim based on HMO financial incentive arrangements. Rather, Petitioners attempt to divert the Court's focus by creating a new issue: in which role—ERISA fiduciary or health care provider—does Petitioner HMO act when implementing the financial incentive scheme? Petitioners ignore the conflicts of interest resulting from Petitioner HMO's self-dealing in the implementation of the financial incentives—the conflicts of interest which compel disclosure of material facts to the ERISA plan participants and beneficiaries. Following the guidance of *Varity Corp.*, disclosure of such material information is a *fiduciary* activity in the discharge of fiduciary duties under ERISA and the common law of trusts, regardless of which hat Petitioner HMO wears when implementing the financial incentives. *Varity Corp.*, 516 U.S. at 502-503.

Amicus curiae respectfully suggests that the Court affirm the Seventh Circuit's reversal of the district court's dismissal of Respondent Patient's claim on the ground that a claim for breach of ERISA fiduciary duty may arise out of financial incentive arrangements *when* the HMO/fiduciary *fails to disclose* the material facts of the resulting conflicts of interest. Upon the issuance of this Court's opinion providing clear guidance regarding breach of ERISA fiduciary duty allegations based on the non-disclosure of conflicts of interest arising out of self-dealing, financial incentive schemes utilized by HMO/ERISA fiduciaries, *amicus curiae* respectfully suggests that Respondent be given the opportunity to replead to include the essential element of failure to disclose, to the extent allowed under the Federal Rules of Civil Procedure.

ARGUMENT

I. ERISA's legislative history shows that common law trust principles provide the key element of an ERISA breach of fiduciary duty claim arising out of fiduciary conflicts of interest: non-disclosure of material facts.

In addition to "'codif[ying] and mak[ing] applicable to [ERISA] fiduciaries certain principles developed in the evolution of the law of trusts," Congress deliberately drafted expansive, nonspecific language of ERISA "'invok[ing] the common law of trusts to define the general scope of their authority and responsibility.'" *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 110 (1989) (quoting H. R. Rep. No. 93-533, p. 11 (1973)) (referring to Restatement of Trusts regarding proper standard of review for fiduciary/administrator benefit denial); *Varity Corp.*, 516 U.S. at 496 (referring to Restatement of Trusts to determine whether activities were employer or fiduciary/administrator).[9]

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[9] Referencing *Central States, Southeast & Southwest Areas Pension Fund v. Central Transport, Inc.*, 472 U.S. 559, 570 (1985); H.R. Rep. No. 93-533, pp. 3-5, 11-13 (1973), 2 Legislative History of the Employee Retirement Income Security Act of 1974 (Committee Print compiled for the Senate Subcommittee on Labor and Public Welfare by the Library of Congress), Ser. No. 93-406, pp. 2350-2352, 2358-2360 (1976) (hereinafter Leg. Hist.); G. Bogert & G. Bogert, Law of Trusts and Trustees § 255, p. 343 (rev. 2d ed. 1992). *See also Curtiss-Wright Corp. v. Schoonejongen*, 514 U.S. 73 (1995) (referring to the Restatement of Trusts to determine propriety of plan amendment); *NLRB v. Amax Coal Co.*, 453 U.S. 322 (1981) (referring to the common law of trusts and noting that ERISA codified strict fiduciary standards); *Nationwide Mutual Ins. Co. v. Darden*, 503 U.S. 318 (1992) (referring to Restatement of Agency to construe the term "employee" in ERISA); *Massachusettes Mutual Life Ins. v. Russell*, 473 U.S. 134 (1985) (concurring opinion referring to

> The principles of fiduciary conduct are adopted from existing trust law, but with modifications appropriate for employee benefit plans. These salient principles place a twofold duty on every fiduciary: to act in his relationship to the plan's fund as a prudent man ..., and to act consistently with the principles of administering the trust for the exclusive purposes previously enumerated....

H.R. Rep. No. 93-533, 93rd Cong., 2d Sess. 36 (1974), *reprinted in* 1974 U.S.C.C.A.N. 4639, 4651.

"ERISA abounds with the language and terminology of trust law," such as "fiduciary" and "administration." *Firestone*, 489 U.S. at 110. Analysis of a "fiduciary" under ERISA and common law trust principles shows that Petitioner HMO is an ERISA fiduciary in connection with the "administration" of the ERISA plan which includes a duty of loyalty owed to Respondent Patient. Trust principles also show that, as an ERISA fiduciary, Petitioner HMO's self-dealing—implementing physician financial incentives designed to increase HMO profits—and the resulting conflicts of interest give rise to the ERISA fiduciary duty to disclose material information to participants and beneficiaries, even absent inquiry.

As does any fiduciary, "[u]nder principles of equity, a [fiduciary of an ERISA plan] bears an unwavering duty of complete loyalty to the beneficiary of the trust, *to the exclusion of the interests of all other parties.*" *NLRB v. Amax Coal Co.*, 453 U.S. 322, 329 (1981) (citing Restatement (Second) of Trusts § 170(1) (1957); 2 A. Scott, Law of Trusts § 170

Restatement of Trusts for guiding principles of fiduciary conduct and determining available remedies).

(1967)) (emphasis added). This broad-based fiduciary duty finds its statutory expression in section 404 of ERISA:

> (a) Prudent man standard of care.
>
> (1) . . . a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and —
>
> (A) for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries [the duty of loyalty "derived from the common law of trusts," *Central States*, 472 U.S. 570-571]; and . . .
>
> (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims....[the standard of care "derived from the common law of trusts," *Central States*, 472 U.S. 570-571]

ERISA § 404, 29 U.S.C. § 1104.

The touchstone of an ERISA fiduciary's duty was properly summarized by the court below as follows:

> The requirement that an ERISA fiduciary act "with an eye single to the interests of the participants and beneficiaries," *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir. 1982), is

> the most fundamental of his or her duties, and "must be enforced with uncompromising rigidity." *NLRB v. Amax Coal Co.*, 453 U.S. 322, 329-30, 101 S. Ct. 2789, 2794-96, 69 L. Ed. 2d 672 (1981) (citation and internal quotation omitted).

Herdrich, 154 F.3d at 371.

Trust law, of course, supplies extensive guidance regarding appropriate and necessary conduct of ERISA fiduciaries fulfilling their duty of loyalty.

> The strict duty of loyalty in the trust law ordinarily prohibits the trustee from investing or managing trust investments in a manner that will give rise to a personal *conflict of interest.*

Restatement (Third) of Trusts, § 227 cmt. (c) (1992) (emphasis added). The Restatement (Second) of Trusts identifies examples of prohibited conflicts of interests:

- a fiduciary may "not profit at the expense of the beneficiary . . . without his *consent*" (Restatement (Second) of Trusts § 170 cmt. 1(a) (1959) (emphasis added);

- a fiduciary violates his duty of loyalty "where he has a *personal interest* in the purchase [of trust property] of such a substantial nature that it might *affect his judgment*" (*Id.*, cmt. 1(c)) (emphasis added);

- a beneficiary cannot avoid a fiduciary's acquiring an interest in trust property if the beneficiary *knows all material facts* that the fiduciary knows or should know (*Id.*, cmt. 2(w)) (emphasis added); and

- a fiduciary may not "accept for himself from a third person any bonus or commission for any act done by him in connection with the administration of the trust . . . . Where a trustee . . . uses his power as shareholder to make an *improper* profit, he is liable for the profit made so." *Id.*, cmt. 1(o) (emphasis added).

However, the Restatement allows certain conflicts of interest *if* the fiduciary gains consent of the beneficiary after *full disclosure of all material facts.* Restatement (Third) of Trusts, § 227 cmt. (c) (1992).

> The prohibition [of investments giving rise to a conflict of interest] also applies to investing in a manner that is intended to serve interests other than those of the beneficiaries . . . .
>
> . . . Such considerations, however, may properly influence the investment decisions of a trustee to the extent permitted by . . . consent of the beneficiaries.

Id. (internal citation omitted). A beneficiary's consent is effective only if the beneficiary knows "the material facts which the trustee knew or should have known." Restatement (Second) of Trusts § 216(2) (1992).

The ERISA fiduciary duty of loyalty thus encompasses a duty to disclose where Petitioner HMO implements the financial incentive arrangements with physicians, serving the interests of Petitioner HMO, in conflict with the interests of the participants and beneficiaries. The duty to disclose requires Petitioner HMO to "inform the beneficiary of . . . the material facts . . . . [and] see that the beneficiary is sufficiently informed so that he understands the character of the transaction." *Id.* § 216 cmt. (k). Indeed, if the fiduciary does not disclose the material faets to the beneficiary, the fiduciary may be held liable for a breach of trust. *Id.* § 216(2) (1992).[10]

Disclosure by Petitioner HMO, even absent inquiry, is essential because "[a] beneficiary, about to plunge into a ruinous course of dealing, may be betrayed by silence as well as by the spoken word." *Eddy v. Colonial Life Ins. Co.*, 919 F.2d 747, 751 (D.C. Cir. 1990) (quoting *Globe Woolen Co. v. Utica Gas & Electric Co.*, 224 N.Y. 483, 489, 121 N.E. 378, 380 (1918) (Cardozo, J.)). In other words, an HMO/ERISA fiduciary's silence—non-disclosure—deceives beneficiaries who blindly trust and rely upon their physicians' treatment decisions and recommendations because they were not informed of the material facts that their treating physicians' judgment may be affected by the financial incentives imposed by the HMO. Silence that deceives "a plan's beneficiaries in order to save [Petitioner HMO] money at the beneficiaries' expense is not to act 'solely in the interest of the participants and beneficiaries.'" *Varity Corp.*, 516 U.S. at 506.

Thus, Petitioner HMO's use of ERISA plan assets to implement physician financial incentives gives rise to conflicting

[10] *See also* Restatement (Second) of Trusts, § 2 cmt. (b) (1959); § 170 cmt. (w) (1992).

loyalties—the duty owed to ERISA plan members to act *solely* in their interest, and the loyalty it owes to its own bottom-line—which trust principles dictate must be disclosed in the discharge of Petitioner HMO's ERISA fiduciary duties, even absent inquiry.

II. Petitioners' dual roles as ERISA fiduciaries and health care providers (or "arrangers of care") give rise to conflicts of interest that must be disclosed to avoid a breach of ERISA fiduciary duty claim.

A. Conflicts of interest arise with Petitioner HMO acting in the dual roles of health care provider and ERISA plan fiduciary.[11]

A brief discussion of the dual roles of Petitioner HMO is helpful for two reasons: (1) it defines and establishes the conflicts of interest alleged, and (2) it emphasizes the impact of such conflicts and the importance of disclosure of the HMO's physician financial incentives to ERISA plan participants and beneficiaries such as Respondent Patient.

First, as provider, Petitioner HMO arranges for health care benefits to be provided through Carle Clinic Association and other participating providers. Petition for Writ of Certiorari at 3. Petitioner HMO implemented a financial "incentive scheme, which invited and encouraged plan fiduciaries to place

[11] *See Bailey v. Blue Cross/Blue Shield of Va.*, 866 F. Supp. 277, 279 (E.D. Va. 1994), *aff'd*, 67 F.3d 53 (4th Cir. 1995) (citing the Fourth Circuit for principle that an ERISA plan administrator occupying dual roles of ERISA fiduciary and plan health care provider acts under a conflict of interest, and thus applying lower level of deference to HMO's discretionary interpretation of group-insurance contract when reviewing HMO's decision to deny benefits).

their own interests ahead of the interests of plan beneficiaries." *Herdrich*, 154 F.3d at 372. Because Petitioner HMO's compensation arrangements with the physician providers were calculated "based on the difference between total plan costs . . . and revenues . . ., an incentive existed for them to limit treatment and, in turn, HMO costs so as to ensure large bonuses." *Id.* Put simply, the less care provided to ERISA plan members, the more profit Petitioners stand to make.

Second, as a fiduciary to the ERISA plan for which health care and administration of health care benefits is provided, Petitioner HMO manages the ERISA plan assets on behalf of ERISA plan participants and beneficiaries. Petition for Writ of Certiorari, Petitioners' Appendix 85a, *Pegram v. Herdrich*, 120 S. Ct. 10 (1999) (No. 98-1949). As fiduciary and plan administrator, in the exercise of discretionary authority, control, and responsibility in the plans' administration and management of plan property and assets, Petitioner HMO is obliged to act "solely in the interest of the participants and beneficiaries." Petitioners' Appendix 85a; ERISA § 404(a)(1).

Petitioners do not address the Seventh Circuit's discussion of or Respondent Patient's allegations showing conflicts of interest arising from Petitioner HMO's dual roles: (1) ERISA fiduciary administering the ERISA plan, and (2) health care provider (or arranger of health care) implementing financial incentives. Petitioners argue that because ERISA contemplates fiduciaries occupying dual roles, and because their financial arrangements with the physicians are specifically allowed, the mere fact of the financial incentives cannot support a breach of ERISA fiduciary duty claim. Petitioners' argument ignores, however, that tolerance does not give fiduciaries unfettered freedom to engage in transactions encumbered with conflicts of interest *in the absence of proper disclosure to*

participants and beneficiaries. *See* Restatement (Third) of Trusts, § 227 (1992).

In *Varity*, the Court recognized that certain conflicts of interest (i.e. dual roles) are countenanced under ERISA where a fiduciary is both "an employer and the benefit plan's administrator," however, the Court also noted an earlier opinion discussing the tenet that the "common law of trusts prohibits fiduciaries from holding positions that create conflict of interest with trust beneficiaries." *Varity*, 516 U.S. at 498 (citing *NLRB v. Amax Coal Co.*, 453 U.S. 322, 329-330, 69 L. Ed. 2d 672, 101 S. Ct. 2789 (1981), Bogert & Bogert, supra, § 543, at 218, 264 (same)). In *NLRB*, the Court stated not only that ERISA codifies "strict fiduciary standards" but also that

> [t]he legislative history of ERISA confirms that Congress intended in particular to prevent trustees "from engaging in actions where there would be a conflict of interest with the fund, such as representing any party dealing with the fund." In short, the fiduciary provisions of ERISA were designed to prevent a trustee "*from being put into a position where he has dual loyalties, and, therefore, he cannot act exclusively for the benefit of a plan's participants and beneficiaries.*"

NLRB, 453 U.S. at 333-34 (quoting S. Rep. No. 93-383, pp. 31, 32 (1973); H. R. Conf. Rep. No. 93-1280, supra, at 309. n17) (emphasis added). Applying common law trust principles to define ERISA's exacting standards of fiduciary loyalty and its concomitant requirement of exclusive devotion to ERISA plan members, a breach of ERISA fiduciary duty claim arises out of Petitioner HMO's divided interests and dual loyalties *when*

Petitioner HMO fails to disclose the material facts of the conflicts of interest.

B. *Case law consistently upholds ERISA section 404's broad fiduciary duty of loyalty, including the fiduciary duty to disclose material information for the protection of ERISA plan participants and beneficiaries.*

Even absent inquiry, an ERISA fiduciary's failure to disclose material information—here, the conflicts of interest arising out of Petitioner HMO's self-dealing compensation system that rewards both the HMO and doctors for dispensing as little health care as possible—breaches section 404's duty of utmost loyalty. That it is material to an ERISA plan member to know the details of conflicts of interest arising out of a financial system that rewards doctors who minimize health care and punishes doctors who provide adequate treatment and testing is self-evident. Indeed in the instant case, when Respondent Patient was required to wait eight days for a necessary diagnostic procedure to be performed at Petitioner HMO's own facility more than fifty miles away, had Respondent Patient known the facts regarding Petitioner HMO's financial incentive arrangements designed to minimize care and maximize profits, Respondent Patient would have been in an informed position to question the physician's orders or seek earlier, preventive testing and treatment on her own.

The materiality of this information also finds support in several circuit court and district court opinions which *amicus curiae* discuss as instructive on the issue of an HMO/ERISA fiduciary's duty to disclose material information—an HMO's physician financial incentives—relating to an HMO's conflicts of interest in the absence of such Supreme Court precedent.

Although not the first circuit to recognize a general fiduciary duty to disclose material information to ERISA plan members, the Eighth Circuit recently applied that duty to a claim alleging facts establishing nearly identical conflicts of interest as Respondent Patient alleged in Count III. In *Shea v. Esensten*, 107 F.3d 625 (8th Cir.), *cert. denied*, 118 S.Ct. 297 (1997), the Eighth Circuit held that the HMO defendants, as ERISA fiduciaries, were required to disclose all material facts, including their payment of incentives to physicians to delay or deny health care. *Id.* at 628-29. The *Shea* plaintiff claimed—successfully for purposes of defeating a dismissal motion—that the HMO breached its fiduciary duty under section 404(a)(1) of ERISA to disclose to ERISA plan members that the HMO paid financial incentives designed to minimize treatment referrals by primary-care doctors. *Id.* at 627.

In *Shea*, despite an obvious need based on family history and symptoms, a covered plan member was unable to obtain a referral from his primary-care physician to a cardiologist; he later died of heart failure. As does Petitioner HMO here,[12] the *Shea* HMO had contracts with its doctors that contained financial incentives designed to minimize referrals. The Eighth Circuit properly applied common law trust principles and found that the HMO, as an ERISA fiduciary, had a duty to disclose the existence of these financial disincentives to all members of ERISA plan, including Mr. Shea. *Shea*, 107 F.3d at 628-29.

The *Shea* court first noted that the Court's opinion in *Varity Corp.* "concluded that ERISA fiduciaries must comply with the common law duty of loyalty, which includes the obligation to deal fairly and honestly with all plan members." *Id.* at 628. In turn, that duty of loyalty includes the requirement

[12] Petitioners' Appendix 86a.

that an ERISA fiduciary "communicate any material facts which could adversely affect a plan member's interest." *Id.* As the court pointed out, "the duty to disclose material information is the core of a fiduciary's responsibility, animating the common law of trusts long before the enactment of ERISA." *Id.* (quoting *Eddy v. Colonial Life Ins. Co. of America*, 919 F.2d 747, 750 (D.C. Cir. 1990)). With regard to the specific claim before it, the *Shea* court observed that

> a financial incentive scheme put in place to influence a treating doctor's referral practices when the patient needs specialized care *is certainly a material piece of information*. This kind of patient necessarily relies on the doctor's advice about treatment options, and *the patient must know* whether the advice is influenced by self-serving financial considerations[—conflicts of interest—]created by the health insurance provider.

Id. (emphasis added).

As in *Shea*, the silence of Petitioner HMO as an ERISA fiduciary creates a danger to all plan members who may seek or receive health care through Petitioner HMO's managed care system—a system that trusting participant and beneficiary patients do not know is designed to enhance Petitioners' profits. In short,

> when an HMO's financial incentives discourage a treating doctor from providing essential health care referrals for conditions covered under the plan benefit structure, *the incentives must be disclosed* and the failure to do so is a breach of ERISA's fiduciary duties.

Shea, 107 F.3d at 629 (emphasis added).

Though not involving HMO financial incentives, the first circuit to recognize an ERISA fiduciary's duty to disclose material information affecting a beneficiary was the District of Columbia Circuit in *Eddy v. Colonial Life Ins. Co.*, 919 F.2d 747, 751 (D.C. Cir. 1990). There, the court held that the failure to give complete and correct material information at a beneficiary's request—and in some circumstances upon the fiduciary's *own initiative*—was a breach of fiduciary duty. *Id.* at 750. Not restricting its holding to a direct inquiry by plan beneficiaries, the *Eddy* court noted the fiduciary duty as stated in the Restatement (Second) of Trusts:

> [The trustee] is under a duty to communicate to the beneficiary material facts affecting the interests of the beneficiary which he knows the beneficiary does not know and which the beneficiary needs to know for his protection in dealing with a third person . . . .

Id. (citing Restatement (Second) of Trusts § 173 cmt. d (1959)). And quoting Justice Cardozo, the *Eddy* court concluded—in words applicable here as well—

> "The [fiduciary] is free to stand aloof, while others act, if all is equitable and fair. He cannot rid himself of the duty to warn and to denounce, if there is improvidence or oppression, either apparent on the surface or lurking beneath the surface, but visible to his practiced eye."

Eddy, 919 F.2d at 752 (quoting Judge Cardozo in *Globe Woolen Co. v. Utica Gas & Electric Co.*, 224 N.Y. 483, 489, 121 N.E. 378, 380 (1918)).

In *Anweiler*, another Seventh Circuit case positing a broad disclosure duty even absent participant inquiry (although ultimately holding that the plaintiff could not recover equitable relief because of an "unclean hands" defense), the court agreed that an ERISA fiduciary breached its duty of loyalty by not giving an insured "full and complete material information" concerning a reimbursement agreement. *Anweiler v. American Elec. Power Serv. Corp.*, 3 F.3d 986 (7th Cir. 1992). More broadly, though, the court noted that a duty of disclosure "exists when a beneficiary asks fiduciaries for information, and *even when he or she does not.*" *Id.* at 991 (citing *Eddy*, 919 F.2d at 750) (emphasis added).

This principle has been applied in the Third Circuit as well: In *Glaziers and Glassworkers Union Local No. 252 Annuity Fund v. Newbridge Securities*, 93 F.3d 1171, 1182 (3d Cir. 1996), the court found that a fiduciary has a legal duty to disclose material facts unknown by the plan member, beneficiary, or participant, but known by the fiduciary and which the beneficiary must know for its own protection. Such a duty need not be triggered by a request for information directed to the fiduciary; rather, certain circumstances known by the fiduciary can give rise to an affirmative duty to disclose—indeed, "absent such information, the beneficiary may have no reason to suspect that it should make inquiry into what may appear to be a routine matter." *Id.* at 1181.[13]

[13] *See also Joyce v. RJR Nabisco Holdings Corp.*, 126 F.3d 166, 174 (3d Cir. 1997) (fiduciary duty to provide complete and accurate information to participants and beneficiaries "extends beyond just

Referring to congressional intent that ERISA's fiduciary provisions incorporate general trust principles, the *Glaziers* court stated:

> Under the common law of trusts, a fiduciary has a fundamental duty to furnish information to a beneficiary. "This duty to inform is a constant thread in the relationship between beneficiary and trustee; it entails not only a negative duty not to misinform, but also an affirmative duty to inform when the trustee knows that silence might be harmful."

Id. at 1180 (citations omitted).

Consistent with *Glaziers* and similar cases, the Fifth Circuit too has imposed a duty to disclose material information upon ERISA fiduciaries, even absent a direct inquiry from a plan participant or beneficiary. In *McDonald v. Provident Indemnity Life Insurance Company*, 60 F.3d 234 (5th Cir. 1995), an ERISA fiduciary of the plaintiff's benefit plan learned of material information regarding prohibitively escalating premiums for small employers such as McDonald Equipment, but failed to disclose that information to either the employer or the beneficiaries. As a result, the company was forced to let its insurance coverage lapse.

Although affirming a judgment for the defendant because McDonald failed to establish a prima facie case of loss to the plan as a whole (a finding in the appeals court not challenged by Petitioners in this case), the Fifth Circuit nonetheless found that the ERISA fiduciary had an obligation

responding to requests about specific benefits").

under section 404 to disclose the material facts concerning a re-rating schedule for group-health-coverage premiums. *Id.* at 237. The court did *not* find that the duty to disclose is triggered only upon inquiry by a plan beneficiary, but rather noted that "[s]ection 404(a) imposes on a fiduciary the duty of undivided loyalty to plan participants and beneficiaries," in addition to a duty to exercise "care, skill, prudence and diligence." An "obvious component of those responsibilities," the *McDonald* court noted, is the "duty to disclose material information." *Id.*

In short, applicable case law applying common law trust principles reveals the obvious: occupying dual roles, Petitioner HMO creates and operates under conflicts of interest and, unless Petitioner HMO voluntarily discloses the material facts of the financial incentive structure designed to minimize health care and maximize Petitioner HMO's profits, Petitioner HMO breaches the ERISA fiduciary duty of loyalty.

C. *The Seventh Circuit's finding that the financial incentive arrangements implemented by Petitioner HMO give rise to an ERISA breach of fiduciary duty claim should be affirmed with the clarification that the breach occurs in the absence of full disclosure by an ERISA fiduciary.*

The Seventh Circuit properly held that while a financial incentive scheme's mere existence does not *automatically* show a breach of fiduciary duty, the implementation of such a scheme can indeed give rise to a breach of ERISA fiduciary duty claim. *Herdrich*, 154 F.3d at 373. The appeals court thus properly reversed the Rule 12(b)(6) dismissal of Respondent Patient's case.

The appeals court properly began the analysis by observing that "[a] fiduciary breaches its duty of care . . . whenever it acts to benefit its own interests." *Id.* at 371. That duty, the appeals court noted, is "directed particularly at schemes 'tainted by a conflict of interest and thus highly susceptible to self dealing.'" *Id.* (quoting *Lowen v. Tower Asset Mgmt., Inc.*, 829 F.2d 1209, 1213 (2d Cir. 1987)). In addition to noting the holdings of *Shea* and *Anweiler* (discussed in section II.B. above), the Seventh Circuit found *Ries v. Humana Health Plan, Inc.*, 1995 WL 669583 (N.D. Ill. Nov. 8, 1995), instructive on the conflict-of-interest issue.

In *Ries*, the defendant health plan, which paid 80% of costs, imposed a subrogation arrangement on its participants, routinely collecting full reimbursement from its participants while at the same time secretly negotiating substantial discounts for its own share of the charges in the first place. Plan members were thus paying more than 20% of the amounts received by the hospitals, and Humana was recouping an effective bonus for itself by paying undisclosed discounted amounts less than 80% of the costs of covered medical expenses.

The *Ries* court held that ERISA did not "permit a plan insurer to recoup more from its insureds than it actually pays out on their behalf under the terms of *undisclosed* discounting arrangements with health care providers." *Id.* at *2 (emphasis added). The court supported this holding by citing an Ohio district court's opinions in *Everson v. Blue Cross & Blue Shield*, 898 F. Supp. 532 (N.D. Ohio 1994), and *McConocha v. Blue Cross & Blue Shield*, 898 F. Supp. 545 (N.D. Ohio 1995), in which that court held that "a plan insurer's *undisclosed* practice of obtaining discounts from health care providers and failing to pass on a proportionate share of the discounts violated" ERISA's fiduciary duties. *Ries*, 1995 WL

669583 at *3 (emphasis added). According to *Ries*, it is this type of "secret self-enhancement" that causes a fiduciary to violate its obligation under section 404. *Id.* Agreeing with the Ohio district court, the *Ries* court held flatly that "[a] fiduciary breaches its duty of loyalty under section 1104(a)(1)(A) [section 404] whenever it acts to benefit its own interests." *Id.* at *7.

In a phrase particularly applicable to the instant case, the *Ries* court went on to hold that a fiduciary's

> covert profiteering at the expense of insureds is inconsistent with its duties of acting 'solely in the interest of the participants and beneficiaries' . . . and of refraining from engaging in self-dealing.

Id. (quoting ERISA § 404(a)(1)(A)).

As Respondent Patient alleged: Petitioner HMO wrongfully self-deals by seeking to maximize HMO profits through the financial-incentive scheme. Petitioners' Appendix 85a-87a. The appeals court below had little difficulty in concluding that a conflict of interest might be present in the challenged arrangement:

> [a]n incentive existed for [doctors] to limit treatment and, in turn, HMO costs so as to ensure larger bonuses. With a jaundiced eye focused firmly on year-end bonuses, *it is not unrealistic to assume that the doctors rendering care under the Plan were swayed to be most frugal when exercising their discretionary authority to the detriment of their membership.*

Id. at 372 (emphasis added).

The appeals court was careful to recognize that although ERISA may allow fiduciaries to adopt dual loyalties,

> the tolerance of dual loyalties does not extend to [a situation] where a fiduciary jettisons his responsibility to the physical well-being of beneficiaries in favor of 'loyalty' to his own financial interests. Tolerance, in other words, has its limits.

Id. at 373. However, the court of appeals stopped short of insisting on allegations showing the absence of the proper course of action for an ERISA fiduciary operating in the dual capacity of fiduciary and for-profit health care provider: *disclosure* of the conflict of interest to the participants and beneficiaries. Thus, with the clarification that a breach of ERISA fiduciary duty based on HMO financial incentives occurs *in the absence of full disclosure* by the HMO/ERISA fiduciary, the Seventh Circuit is properly affirmed.

III. Petitioner HMO's argument that it implements the financial incentive arrangements in its health care provider role misses the point: conflicts of interest arise out of self-dealing financial incentives that, in its ERISA fiduciary role, Petitioner HMO must disclose or there is a breach of ERISA's broad fiduciary duties.

The following discussion proceeds on the understanding that Petitioners' financial incentive structure pays increased profits and bonuses to the physicians. However, if Petitioners' assert that the benefits of the financial incentives are paid and

reaped only at the provider level, then ERISA is not implicated at all, and this suit should not be in federal court but in state court proceeding on pure state-law, quality of health care issues addressing the effects of the financial incentives on the health care provided. *See New York State Conf. of Blue Cross & Blue Shield Plans v. Travelers Ins. Co.*, 514 U.S. 645 (1995).

Even if Petitioner HMO implements financial incentive arrangements in its health care provider role, Petitioner HMO's self-dealing requires Petitioner HMO to act in its ERISA fiduciary role to avoid the evils inherent in the resulting conflicts of interest through full disclosure of the material facts, as discussed in Sections I and II above. Here, Petitioner HMO acts as an ERISA fiduciary administering an ERISA plan when, under competing interests *and without disclosure*, financial incentives are paid out of ERISA plan assets to reward physicians for providing minimal care. Such "administration" of an ERISA plan (a trust) and the failure to disclose the conflict of interests arising out of a self-dealing financial incentive scheme implemented with ERISA plan assets clearly falls within the category of a fiduciary act under *Varity Corp.*

In *Varity Corp.*, the Court directed that the determination of whether a defendant's actions "fall within the statutory definition of 'fiduciary' acts," is achieved by looking "to the common law, which, over the years has given to terms such as 'fiduciary' and trust 'administration' a legal meaning to which, we normally presume, Congress meant to refer." *Varity Corp.*, 516 U.S. at 502 (citation omitted).

> There is more to plan (or trust) administration than simply complying with the specific duties imposed by the plan documents or statutory regime; it also includes the activities that are

> 'ordinary and natural means' of achieving the 'objective' of the plan. Indeed, the primary function of the fiduciary duty is to constrain the exercise of discretionary powers which are controlled by no other specific duty imposed by the trust instrument or the legal regime. If the fiduciary duty applied to nothing more than activities already controlled by other specific legal duties, it would serve no purpose.

Varity Corp., 516 U.S. at 504 (citing *Bogert & Bogert*, *supra*, § 551, at 41-52). Indeed, the Court found that

> *[c]onveying information* about the likely future of plan benefits, thereby permitting beneficiaries to make an informed choice about continued participation, *would certainly seem to be an exercise of a power 'appropriate' to carrying out an important plan purpose.*

Varity Corp., 516 U.S. at 502 (conclusion from discussion of the law of trusts) (emphasis added).

Likewise, "disclosure" of the financial incentives in the administration of the ERISA plan is certainly an "ordinary and natural means" for Petitioner HMO to discharge its ERISA fiduciary duties "solely in the interest of the participants and beneficiaries," and "achiev[e] the 'objective' of the plan"—to provide health care "benefits to participants and their beneficiaries." *Varity Corp.*, 516 U.S. at 504; 29 U.S.C.A. § 1104. The Court's discussion in *Varity Corp.* shows that, more than merely determining coverage of benefits and the proper course of treatment as provided in the plan documents, "administration" of the ERISA plan encompasses Petitioner

HMO's duty to disclose the material facts of the financial incentives creating conflicts of interest.

CONCLUSION

Common law trust principles, applied as ERISA legislative history intended, establish that conflicts of interests in Petitioner HMO's intertwined dual roles of ERISA fiduciary and health care provider give rise to a claim for breach of fiduciary duty *in the absence of full disclosure* of the financial incentive arrangements. Accordingly, the Seventh Circuit's reversal of the district court's dismissal of Respondent Patient's claim on the grounds that a claim for breach of ERISA fiduciary duty may arise out of a financial incentive scheme is properly affirmed with the added clarification that the breach occurs in the absence of full disclosure of material facts regarding conflicts of interest necessarily resulting from the implementation of the financial incentive arrangements.

Respectfully submitted,

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22